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SUBJECT: ARMENIA'S BANKING SECTOR: IT NEEDS MORE THAN REGULATION

1. (U) Sensitive but unclassified. Please protect accordingly. Not for internet distribution.

SUMMARY

2. (SBU) Armenia's Central Bank (CBA) has outlined a new reform program to strengthen the banking sector. But bank officials caution that legal and regulatory reforms alone would do little to improve bank intermediation. Despite significant consolidation and the recent closure of insolvent banks, Armenia's banks still struggle to attract deposits and are even worse at lending money. Improving the banking sector is a priority for the government and the international donor community, as high lending rates and poor access to capital hamper small enterprises and raise costs for all businesses. While touting reforms, CBA officials cite not the regulatory environment but cultural resistance to banking and a strong reluctance of businesses to open their books as the greatest impediments to a strong intermediating banking sector. End Summary.

CENTRAL BANK SETS OUT REFORMS TO IMPROVE INTERMEDIATION

3. (SBU) Armenia's banks do a poor job of attracting deposits and lending money: the assets of Armenia's 19 solvent banks equal only 17 percent of GDP (compared to 70 percent in the U.S.). We met recently with CBA Board Member Vache Gabrielyan to discuss the CBA's reform strategy to increase intermediation by raising the confidence of depositors in banks, and of banks in borrowers. In 2004 the CBA will continue measures that force banks to be stronger combined with new legislation to strengthen creditor rights and a new deposit guarantee program. The CBA will propose a draft law on the registration of collateral along with legislative amendments to allow non-judicial foreclosures in order to encourage collateral based lending. Currently the difficulty of foreclosing on collateral, due to court inefficiencies and inadequate laws on collateral and secured transactions, discourages banks from lending to unknown borrowers.

SOUNDER BANKS STILL MUST WORK TO ATTRACT DEPOSITS

4. (SBU) Over the last two years, the Central Bank strengthened the banking sector by liquidating insolvent banks and raising statutory capital requirements. Even though banks are now sounder, they still must work to attract deposits. As banks expand services and technologies, and as insolvent and uncompetitive banks are weeded out, Armenians should become more willing to save their money in banks. Persistent, if unjustified, worries over the soundness of banks combined with privacy concerns and the fear of government monitoring keep much of Armenia's savings out of banks and in the cookie jar.

BANK LENDING REMAINS WEAK

5. (SBU) Banks are even worse at lending money than they are at attracting deposits: the safest commercial banks like HSBC are flush with cash. While businesses cite high interest rates (averaging 19 percent) as the primary obstacle to borrowing, banks cite the lack of good borrowers. Nick Gilmore, the CEO of HSBC, comments that Armenian firms don't want to share their books with their banker. "Armenians keep several sets of books," he says, "one for the tax authorities, one for their partners -- because they are all cheating their partners -- and one for their wives. We want the real books and ultimately they don't want anyone to have real records. They will offer collateral, but we are not in the collateral business. We don't want property, we want to know our client."

TRUST, BUT HOW TO VERIFY?

16. (SBU) In Armenia, knowing your client can be hard to do. In a culture where entrepreneurs look to family, clients and personal connections -- not banks -- for working capital, potential borrowers lack reliable financial records and adequate business plans. The fact that many Armenians are paid in cash, have no bank accounts and have likely misrepresented their incomes on any government forms gives banks very little verifiable information on which to base decisions. Banks lack expertise in evaluating risk anyway, and base their decisions on their own histories with clients rather than the clients' ability to service the loans.

COMMENT: IT'S A QUESTION OF TRUST

17. (SBU) The greatest burdens on Armenia's banking sector are cultural. Historical mistrust of banks persists and accurate bookkeeping is anathema to local businesses. (Note: In 2003 Armenia had only 1 percent profit tax revenues despite 14 percent GDP growth. End Note.) Paradoxically, potential borrowers would rather risk collateral than provide information: Armenia's largest enterprises eschew borrowing from HSBC, the bank with the lowest lending interest rates. Armenia is a cash economy, and people and businesses are reluctant to submit their accounts to scrutiny. Banks understandably balk at lending money to consumers who keep no bank accounts and to businesses who show no profit. The dearth of lending to small and medium size enterprises deprives banks of the broad portfolios, not mention experience and expertise, which would make lending at lower rates profitable.

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